Supreme Court, U.S.
FILED
MAY 10 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-1424

In the Supreme Court of the United States

OCTOBER TERM, 1988

THE STUART-JAMES COMPANY, INC. AND MARC N. GEMAN, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

WILLIAM C. BRYSON
Acting Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

LUCINDA O. MCCONATHY
Special Counsel
Securities and Exchange Commission
Washington, D.C. 20549

QUESTION PRESENTED

Whether the Securities and Exchange Commission, in affirming a censure and $500 fine imposed on petitioners by the National Association of Securities Dealers, reasonably interpreted the phrase "unrealized profit" as used in the Commission's net capital rule not to include an "unallocated expense reserve" received by an underwriter.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	7
Conclusion	13

TABLE OF AUTHORITIES

Cases:

Aleknagik Natives, Ltd. v. *United States*, 635 F. Supp. 1477 (D. Alaska 1985), aff'd, 806 F.2d 924 (9th Cir. 1986)	10
Anderson v. *Butz*, 550 F.2d 459 (9th Cir. 1977)	10
Bowles v. *Seminole Rock Co.*, 325 U.S. 410 (1945)	7
Chamber of Commerce of United States v. *OSHA*, 636 F.2d 464 (D.C. Cir. 1980)	9
Herron v. *Heckler*, 576 F. Supp. 218 (N.D. Cal. 1983)	10
Kahn v. *United States*, 753 F.2d 1208 (3d Cir. 1985)	12
Lewis v. *Weinberger*, 415 F. Supp. 652 (D.N.M. 1976)	10
Lowell H. Listrom & Co. v. *SEC*, 803 F.2d 938 (8th Cir. 1986)	7
L. R. Willson & Sons, Inc. v. *Donovan*, 685 F.2d 664 (D.C. Cir. 1982)	9
Morton v. *Ruiz*, 415 U.S. 199 (1974)	10
Nguyen v. *United States*, 824 F.2d 697 (9th Cir. 1987)	11
Perri v. *Department of the Treasury*, 637 F.2d 1332 (9th Cir. 1981)	11
Powderly v. *Schweiker*, 704 F.2d 1092 (9th Cir. 1983)	10
Udall v. *Tallman*, 380 U.S. 1 (1965)	7
United States v. *Heller*, 726 F.2d 756 (Temp. Emer. Ct. App. 1983)	9
United States v. *Larionoff*, 431 U.S. 864 (1977)	7
United States v. *Mowat*, 582 F.2d 1194 (9th Cir.), cert. denied, 439 U.S. 967 (1978)	11-12
Welch v. *United States*, 750 F.2d 1101 (1st Cir. 1985)	11

Statutes and regulations:

	Page
Administrative Procedure Act, 5 U.S.C. 551 *et seq.*	5
5 U.S.C. 552(a)(1) (Freedom of Information Act)	6, 11, 12
5 U.S.C. 552(a)(1)(D)	6, 10
5 U.S.C. 553(b)(A)	6
Securities Exchange Act of 1934, § 15(c)(3), 15 U.S.C. 78*o*(c)(3)	2
17 C.F.R.:	
Section 240.15c3-1	2
Section 240.15c3-1(a)	2
Section 240.15c3-1(c)(2)(viii)	3

Miscellaneous:

1 K.C. Davis, *Administrative Law Treatise* (1979)	13
National Association of Securities Dealers Manual (1984)	13

In the Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-1424

THE STUART-JAMES COMPANY, INC. AND
MARC N. GEMAN, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-12a) is reported at 857 F.2d 796. The opinion of the Securities and Exchange Commission, Securities Exchange Act Release No. 24,590 (June 15, 1987) (Pet. App. 14a-19a), is unofficially reported at 38 S.E.C. Docket 1118.

JURISDICTION

The judgment of the court of appeals was entered on September 20, 1988. A petition for rehearing was denied on November 17, 1988 (Pet. App. 13a). The petition for a writ of certiorari was filed on February 15, 1989. The jurisdiction of the Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner The Stuart-James Company, Inc. (Stuart-James) is a securities broker-dealer firm that is registered with the Securities and Exchange Commission (Commission) and is a member of the National Association of Securities Dealers (NASD). Petitioner Marc N. Geman is the firm's executive vice-president. Petitioners contend that the court of appeals erred in affirming a Commission order which, in turn, affirmed disciplinary action taken against petitioners by the NASD based on a finding that petitioners had violated the net capital rule, Securities Exchange Act Rule 15c3-1, 17 C.F.R. 240.15c3-1 (Pet. App. 21a-84a).

1. The net capital rule was promulgated by the Commission pursuant to its statutory authority "to provide safeguards with respect to the financial responsibility" of brokers and dealers. See Section 15(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(c)(3). The net capital rule prescribes minimum liquidity standards for broker-dealer firms to assure that they maintain sufficient liquid assets to satisfy customer claims promptly. Essentially, the rule requires that a firm's "aggregate indebtedness" never exceed 1500% of its "net capital," as each term is defined in the rule. 17 C.F.R. 240.15c3-1(a). A broker-dealer is required to be in compliance with the rule—that is, to have the required net capital—at all times.

The net capital rule requires a broker-dealer to take account of its underwriting commitments in determining its compliance with the rule. A broker-dealer may underwrite securities on a "firm commitment" basis. In such a transaction, the broker-dealer purchases securities from the issuing company at a discount from the full public offering price and assumes the risk of reselling those securities to the public. The difference between the price the under-

writer pays to the issuer and the public offering price is known as a "concession." The underwriter retains the concession as compensation, although part of it may be paid to its salespersons as commissions. See Pet. App. 10a. In addition, an underwriter generally receives an expense allowance from the issuer. This allowance may be limited to actual expenses or it may be a fixed amount that the underwriter is entitled to retain even if actual expenses are less.

In a firm commitment offering, an underwriter assumes the risk that it will not be able to resell the securities to the public at the full offering price and that they will decline in value. Accordingly, the Commission's net capital rule requires a broker-dealer, at the commencement of the offering, to deduct from its net capital a so-called "haircut" of 30% of the public offering price of the securities. 17 C.F.R. 240.15c3-1(c)(2)(viii). The net capital rule, however, allows the haircut to be reduced by the amount of the firm's "unrealized profit" from the offering. *Ibid.*

2. On November 1, 1984, Stuart-James entered into a firm commitment underwriting agreement with U.S. Electronics Group (USEG). Pet. App. 16a. Stuart-James agreed to purchase $1,740,000 worth of securities in return for a concession of $174,000, a 10% discount from the full public offering price. *Ibid.* The concession was to serve as Stuart-James' compensation for underwriting the transaction. *Id.* at 3a. The underwriting agreement also called for USEG to pay to Stuart-James an "unallocated expense reserve" of $120,000, under an arrangement in which Stuart-James did not have to account to USEG for its actual expenses, but could keep any unexpended portion of the reserve for itself. *Id.* at 16a.

On November 13, 1984, the NASD staff ascertained that when Stuart-James entered into the USEG underwriting agreement, its net capital was not sufficient to

allow it to underwrite the transaction while staying in compliance with the net capital rule. Pet. App. 3a. Thereafter, a District Business Conduct Committee of the NASD (DBCC) filed a complaint against petitioners alleging that they had conducted a securities business with insufficient net capital. *Id.* at 4a. After a hearing, the DBCC found that petitioners had violated the net capital rule, but did not impose sanctions on petitioners because it found mitigating circumstances. *Ibid.* On review, the NASD Board of Governors agreed that petitioners had violated the net capital rule, but disagreed with the DBCC's finding of mitigating circumstances. Accordingly, the Board imposed a sanction on petitioners of a censure and a fine of $500. *Ibid.*

3. Petitioners appealed to the Commission from the NASD's disciplinary action. Pet. App. 14a-20a. Independently reviewing the record, the Commission affirmed the sanctions. *Id.* at 15a. Petitioners contended that the NASD had erred in finding a net capital deficiency because it had incorrectly computed the "unrealized profit" that Stuart-James expected to earn from the USEG underwriting. Petitioners asserted that its "unrealized profit" included not only the concession but also the "unallocated expense reserve" it received, because both items represented revenue to the underwriter. Pet. App. 16a-17a. The NASD, however, had included only the concession in determining Stuart-James' "unrealized profit." *Ibid.*

The Commission rejected petitioners' argument. Pet. App. at 17a-18a. It explained that "the precise amount of [unrealized profit] cannot be definitely ascertained at the time the underwriter makes his commitment," but "it is reasonable to assume that the concession or discount an underwriter is slated to receive contains a substantial element of profit." *Id.* at 17a. Thus, the Commission noted,

both its staff and the NASD have "consistently treated the entire amount of the underwriter's concession as unrealized profit in determining net capital," even though some portion of the concession may be used for expenses. *Ibid.* In contrast, the purpose of the expense reserve "is to reimburse the underwriter for expenses incurred in connection with the underwriting" (*ibid.*), and the expense reserve, therefore, cannot be assumed to represent "unrealized profit" to the underwriter. The Commission noted that the USEG prospectus had even disclosed that the "expense allowance at issue might not be sufficient to cover the firm's expenses." *Id.* at 18a. Accordingly, the Commission agreed with the NASD that under a proper interpretation of the term "unrealized profit," Stuart-James could not reduce its haircut from the USEG transaction by treating both the amount of its expense allowance as well as the concession as "profit."

4. The court of appeals denied petitioners' petition for review. Pet. App. 1a-12a. The court concluded that the Commission's interpretation of the term "unrealized profit" to include the concession to Stuart-James, but not the expense allowance, was reasonable. The court also found that the Commission's interpretation had not been applied to petitioners in violation of the Administrative Procedure Act (APA), 5 U.S.C. 551 *et seq.* Pet. App. 10a-11a.

The court initially observed that the Commission's interpretation "of regulations that it has promulgated under a statute Congress has charged it with enforcing" is entitled to "considerable deference." Pet. App. 9a. The court then explained that "[i]n interpreting the net capital rule, the Commission is charged with the paradoxical task of measuring something that does not yet exist: the 'unrealized profit' on a transaction that has not yet occurred." *Ibid.* The Commission's choice to do so by using the firm's concession as a measure of its "unrealized profit" is "a

reasonable one," considering that "[t]his measure is necessarily only an approximation of actual profits, omitting several other factors that will in practice raise or lower the actual profits that a firm realizes on a transaction." *Id.* at 10a. The court added that "there is no indication that the Commission has ever interpreted the phrase differently." *Ibid.*

The court also rejected petitioners' contention that the Commission had improperly failed to publish its interpretation of the net capital rule under the APA's rule making provisions, 5 U.S.C. 553(b)(A), or under the Freedom of Information Act (FOIA) provisions of the APA, 5 U.S.C. 552(a)(1). Pet. App. 10a-11a. The APA's rulemaking provisions did not apply because those provisions require publication only of "substantive rules," and specifically exclude from that requirement "interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice." 5 U.S.C. 553(b)(A). The Commission's interpretation of the net capital rule, the court explained, "clearly falls within [the] statutory rubric" of an interpretive rule and thus did not have to be published. Pet. App. 11a. Likewise, the FOIA publication provisions do not apply to the Commission's interpretation of "unrealized profit." Those provisions apply only to "substantive rules," "statements of general policy," or "interpretations of general applicability," 5 U.S.C. 552(a)(1)(D), and the Commission's interpretation of "unrealized profit" is not one of these. Pet. App. 11a.

The court found no abuse of discretion in the Commission's resolution of the precise meaning of "unrealized profit" in an adjudicatory proceeding in which petitioners were sanctioned. Pet. App. 11a-12a. While it viewed that procedure as not an "ideal" one, the court pointed out that "petitioners were remiss in proceeding with the USEG underwriting without seeking a clarification of the mean-

ing of that term and ensuring that they were in compliance with the net capital rule." *Id.* at 12a. The court thus affirmed the finding of a violation and the imposition of a "mild sanction" on petitioners. *Ibid.*

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Petitioners renew their contention (Pet. 3-6) that the term "unrealized profit" under the net capital rule should be interpreted to include not only an underwriter's concession, but also its unallocated expense allowance. The Commission's interpretation to the contrary, however, is well within the agency's discretion to explain the meaning of its rule. Because the Commission is interpreting its own rule, promulgated under a statute that Congress has charged it with administering, the court of appeals correctly decided that the interpretation is entitled to substantial deference. The Commission's interpretation is "of controlling weight unless it is plainly erroneous or inconsistent with the regulation." *United States* v. *Larionoff*, 431 U.S. 864, 872 (1977) (quoting *Bowles* v. *Seminole Rock Co.*, 325 U.S. 410, 414 (1945)). See also Udall v. *Tallman*, 380 U.S. 1, 16 (1965) (this Court "shows great deference to the interpretation given the statute by the officers or agency charged with its administration. * * * When the construction of an administration regulation rather than a statute is in issue, deference is even more clearly in order."); *Lowell H. Listrom & Co.* v. *SEC*, 803 F.2d 938, 941 (8th Cir. 1986). The Commission's interpretation of the phrase "unrealized profit" is plainly not subject to question under that standard.

The Commission uses an objective, bright-line measure to determine a broker-dealer's "unrealized profit" from a firm commitment underwriting. It includes an underwriter's entire concession in "unrealized profit," and excludes from that category the firm's "unallocated expense" allowance. Although there may be an element of expense in the underwriter's concession, and an element of profit in an expense allowance, the Commission's approach focuses on the general nature of those different types of payments for purposes of adjusting an underwriter's "haircut" as a result of a public offering. "[A]t least in the common situation where the underwriter is separately reimbursed for many of its out-of-pocket expenses, it is reasonable to assume that the concession or discount an underwriter is slated to receive contains a substantial element of profit," while "[t]he same assumption cannot be made for the expense reserve." Pet. App. 17a.[1]

The Commission's interpretation of the net capital rule, in contrast to that of petitioners, accords with the rule's plain language. The net capital rule provides that a haircut may be reduced by "unrealized profit"—not "revenue," or "payment," or "proceeds," or "receipts." Petitioners, however, ignore this language by arguing that "there is no reason to treat concessions differently from such [expense] allowances, because both mean *revenue* to the company." Pet. 6 (emphasis added). "Unrealized profit" is not equiva-

---

[1] Even if some portion of the expense allowance does include an element of profit, the Commission's formula permits a rough correction for that possibility because the entire concession is included, even though a portion of that may actually be used for the underwriter's expenses. Under the interpretation urged by petitioners (Pet. 5-6), instead of being required to *correct* the overstatement of profit that results from including the entire concession as profit, a firm would be permitted to *exaggerate* it by counting its entire expense allowance as unrealized profit in addition to the entire concession.

lent to "unrealized revenue," however, because profit is what remains of revenue after expenses are paid. Counting both the concession and the expense allowance as unrealized profit would result in all expenses being treated as though they were profits, a result at variance with the rule's text and purposes.[2]

The Commission's approach also greatly simplifies administration of the net capital rule. Any other reasonably accurate formula would likely require broker-dealers to construct estimates of their anticipated expenses and profit for each underwriting transaction, defeating the Commission's purpose of assuring ready compliance with the net capital rule in this context. Neither the NASD nor the Commission would have an efficient means of testing such broker-dealer predictions without detailed and painstaking review, and a brokerage firm could not know in advance whether its predictions about its "unrealized profit"—and the net capital calculation based on those predictions—would be sufficient to obtain NASD approval to enter an underwriting. In contrast, the Commission's interpretation allows its staff, the NASD, and the broker-dealer to calculate the broker-dealer's net capital position on an objective basis at the commencement of an

---

[2] Accordingly, the cases on which petitioners relies (Pet. 8-9) for the general notion that an agency may not use an interpretation to depart from the language of a rule are completely inapplicable in this case. See *L. R. Willson & Sons, Inc.* v. *Donovan*, 685 F.2d 664, 675 (D.C. Cir. 1982) (rejecting agency interpretation of "impractical" that strayed from its "ordinary meaning"); *Chamber of Commerce of United States* v. *OSHA*, 636 F.2d 464 (D.C. Cir. 1980) (agency could not interpret its statute and rules to require that employee must be compensated for accompanying OSHA inspector on a plant tour without going through APA rulemaking provisions); *United States* v. *Heller*, 726 F.2d 756, 762 (Temp. Emer. Ct. App. 1983) (discussing general principles of construing regulations).

offering, without relying on the broker-dealer's predictions about its anticipated expenses.

2. Petitioners next insist (Pet. 8-10) that because the Commission has not published its interpretation of the term "unrealized profit" in the Federal Register, it cannot apply that interpretation to them. Contrary to petitioners' contention, however, the APA, 5 U.S.C. 552(a)(1)(D), does not require such publication. That section requires publication of "statements of general policy and interpretations of general applicability." *Ibid.* Publication is not required when an administrative interpretation only clarifies or explains an existing law or regulation. See, *e.g.*, *Anderson* v. *Butz*, 550 F.2d 459, 463 (9th Cir. 1977). Publication is required only when an agency "adopt[s] new rules or substantially modif[ies] existing rules, regulations, or statutes and thereby cause[s] a direct and significant impact upon the substantive rights of the general public." *Lewis* v. *Weinberger*, 415 F. Supp. 652, 659 (D.N.M. 1976); see also *Powderly* v. *Schweiker*, 704 F.2d 1092, 1098 (9th Cir. 1983) (interpretation of term in Social Security Act and regulation did not have to be published in Federal Register because it only explained what the more general term in the Act and regulation provided); *Aleknagik Natives, Ltd.* v. *United States*, 635 F. Supp. 1477 (D. Alaska 1985), aff'd, 806 F.2d 924 (9th Cir. 1986) (interpretation of statute by Secretary of the Interior was not required to be published under the APA because it merely clarified or explained what the Secretary believed the statute meant).[3]

---

[3] The cases relied on by petitioners (Pet. 9) are not to the contrary. See *Morton* v. *Ruiz*, 415 U.S. 199, 231 (1974) (APA provision held applicable to eligibility requirements imposed by an agency because the agency was making new rules to fill a gap left by Congress); *Herron* v. *Heckler*, 576 F. Supp. 218, 230, 233 (N.D. Cal. 1983) (certain un-

The Commission's interpretation of the term "unrealized profit" was just such a clarification or explanation. It did not introduce new concepts into the rule or new requirements for the calculation of net capital. Rather, as the court of appeals noted, it "merely explained an already existing regulation." Pet. App. 11a.

Even if the APA had required publication of the Commission's intepretation of the term "unrealized profit," the failure to do so would not prevent the imposition of sanctions on petitioners in the circumstances of this case. Petitioners rely (Pet. 9) on the last paragraph of Section 552(a)(1) of the APA, which provides, "Except to the extent that a person has actual and timely notice of the terms thereof, a person may not * * * be adversely affected by, a matter required to be published in the Federal Register and not so published." Consistent with the underlying purpose of the APA, however, the courts have held that enforcement of an unpublished interpretation should be barred only if enforcement would be unfair or arbitrary under the particular facts presented. *Nguyen* v. *United States*, 824 F.2d 697, 701 (9th Cir. 1987). When the party subject to sanction has reason to know that his conduct is prohibited, and the unpublished interpretation is consistent with the published statute or regulation being interpreted, the courts have allowed the unpublished interpretation to be enforced. *E.g.*, *Welch* v. *United States*, 750 F.2d 1101, 1110 (1st Cir. 1985); *Perri* v. *Department of the Treasury*, 637 F.2d 1332, 1337 (9th Cir. 1981); *United States* v.

---

published eligibility requirements held not enforceable because they introduced entirely new concepts not found in the governing statute and regulations).

Mowat, 582 F.2d 1194, 1199-1204 (9th Cir.), cert. denied, 439 U.S. 967 (1978). *Cf. Kahn* v. *United States*, 753 F.2d 1208, 1222-1223 n.8 (3d Cir. 1985). See also 1 K. C. Davis, *Administrative Law Treatise* § 5:12, at 348 (1979). The Commission's interpretation of the term "unrealized profit" is consistent with the language and purposes of the net capital rule, and petitioners had ample reason to know of that interpretation.[4] Accordingly, they have no cause for complaint under Section 552(a)(1) of the APA.

---

[4] Petitioners knew from the published regulation that profits, not revenues, are permitted to reduce the haircut that must be taken on a firm-commitment underwriting. They also knew prior to the violation in this case that the NASD treated only a portion of the revenues from a firm-commitment underwriting as unrealized profit for purposes of the net capital rule. When petitioners requested the NASD's advance permission to engage in the USEG underwriting, as required by NASD rules (NASD Manual ¶ 2151 (1984)), the NASD staff initially denied the request because they calculated that the firm did not have enough net capital. The calculation was made treating 10% of the offering amount as unrealized profit. R. 130, 166. Thus, petitioners knew that the NASD did not consider as "unrealized profit" the total revenues, which amounted to approximately 16% of the underwriting when the expense allowance was added to the concession. Since the concession in the proposed underwriting was 10% of the offering, the petitioners had notice that the concession was the only part of revenues to be treated as unrealized profit in calculating net capital.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

LUCINDA O. MCCONATHY
Special Counsel
Securities and Exchange Commission

MAY 1989

U.S. GOVERNMENT PRINTING OFFICE: 1989—241-699:00246